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December 2023
Quarter in Review

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A BLISTERING RALLY TO END 2023

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Markets staged a vigorous rally in the last two months of the year, with both equities and bonds posting high returns for the fourth quarter. US data showed signs of slowing in the economy, while inflation came down to levels not far from the central banks' 2% target in both the US and Eurozone. As inflation is expected to fall further over the next 12 months, central banks suggested policy rates may have peaked, and Federal Reserve (Fed) officials spoke to the potential for rate cuts in 2024. Global asset markets rose as lower policy rates were increasingly priced in and conviction in a soft landing for the economy – involving falling inflation and growth but no recession – deepened. Bond yields fell sharply, benefiting both bond and equity markets.

US

US GDP expanded strongly, rising by 4.9% quarter-on-quarter (q/q) annualised and up from 2.1% in Q2. This was the fastest growth rate since Q4 2021 and was supported by a 10.0% rise in private domestic investment, as well as strong gains in consumer (3.1%) and government spending (5.8%).

However, some data in Q4 showed signs of an economic slowdown. Labour-market data weakened, with non-farm payrolls in October showing the addition of 150k non-farm payrolls, down from 297k in September. The unemployment rate rose to 3.9%, the highest level since January 2022. In November, weekly initial jobless claims rose as high as 231k, the highest since August. This is still low by historical standards, but is up from the sub-200k level seen earlier in 2023.

Price pressures have also come down. November consumer prices rose by 3.1% year-on-year (y/y) at the headline level, while core prices were up by 4.0% y/y. The former was down slightly from October's rate (3.2%), driven by a fall in energy prices, while core prices were unmoved.

This led the Fed to a somewhat more dovish policy stance at its December meeting, at which it left the federal funds rate unchanged at a target range of 5.25-5.50%, as expected. Its updated economic projections showed that the median forecast of the key rate by Federal Open Market Committee members suggested 75 basis points (bps) of easing in 2024, up from the 50bps estimated in September. This was supported by lower expected core inflation (3.2% y/y for core PCE in 2023, down 0.5% from September, while it lowered the forecast for 2024 to 2.4% from 2.6%). Regarding potential rate-cutting, Powell stated that policymakers are aware that "hanging on too long" is a risk the Fed is aiming to avoid.

Europe

In the Eurozone, data was mixed. Q3 GDP fell by 0.5% q/q annualised and below consensus forecasts of no change. This was down from a 0.5% rise in Q2 and was driven by falls in Germany (-0.5%) and Ireland (-6.9%) over the period, while GDP rose 0.4% in both Italy and France while Spain grew 1.3%. Industrial production, excluding construction, fell by 0.7% m/m in October, and was illustrative of continued weakness in industry following a 1.0% fall in September.

However, there were some signs of positive momentum in sentiment in Q4. The Eurozone composite PMI increased, rising from 46.5 in October to 47.0 in December, though it remained in contractionary territory (below 50). In Germany, the Ifo business confidence survey showed improvements in October. Sentiment indices on the current economic situation and business expectations rose from September, with the former up for a third consecutive month.

Meanwhile, inflation continued to fall. Headline prices were up by 2.4% y/y in November, the slowest rise since July 2021 and down from 2.9% in October. Core price rises decelerated to 3.6% y/y in November from 4.2% in October. This, along with the still-soft economic backdrop, led rate markets to price in monetary easing from the European Central Bank (ECB) as early as April 2024.

The ECB left its deposit rate unchanged at 4.0% at its December meeting but remained hawkish, with President Lagarde stating that the bank "did not discuss rate cuts at all" and that "we should absolutely not lower our guard" in the fight against inflation. At the same time, there were dovish signals, as Lagarde said that growth risks "remain tilted to the downside", and a reference to inflation staying "too high for too long" was removed from the ECB's meeting statement.

UK

In the UK, the Chancellor's Autumn statement in November showed that increased inflation resulted in higher nominal tax receipts. This allowed the government to announce some fiscal easing, including reduced national insurance rates, while spending was left "broadly unchanged". As a result, the Office for Budget Responsibility projects that the budget deficit will fall from 5.0% of GDP in fiscal year 2022/23 (year to 5 April 2023) to 4.5% in 2023/24. Meanwhile, the UK GfK consumer confidence barometer rose to -22 in December, having been as low as -30 in October. The composite PMI for November also rose back into expansionary territory (above 50) and increased further in December to a six-month high of 51.7.

China

Q3 GDP in China rose by 4.9% y/y, above consensus expectations of 4.5%. Other activity data also showed healthy activity for November. There were upside surprises for both retail sales and industrial production, which expanded by 10.1% y/y and 6.6%, respectively. Fixed-asset investment rose by 2.9% y/y, below expectations of 3.1%. In October, China's government approved the issuance of CNY 1 trillion ($137bn, €129bn) of government bonds, aimed at providing infrastructure projects for areas hit by disasters, with half to be spent in 2023 and the other half in 2024. This is projected to raise the 2023 budget deficit from 3.0% of GDP to 3.8%, and is likely to support activity over the next 12 months.

MARKET ROUND-UP

Equities

Over the quarter, global equities – as represented by the MSCI All Country World Index (ACWI) – rallied by 9.5% (6.5% in euro terms).

As inflation continued to fall in the US and Europe, markets increasingly priced in interest rate cuts for 2024. Bond yields fell, and conviction in a soft landing for the global economy rose.

Developed-market equities returned 10.0% in local currency terms (6.9% in euros) over the quarter.

Small-cap equities rose by 10.4% (7.9% in euros), outperforming large caps as falling interest rates towards the end of the period helped support the asset class.

Emerging-market (EM) equities were up by 5.6% (3.4% in euros), underperforming developed markets. The asset class was supported by rallies in certain markets like Mexico (15.8% in local) and Brazil (14.6% local) amid easier financial conditions.

Bonds

Bond yields fell over the quarter (and so prices rose) as markets priced in interest rate cuts for 2024. The ICE BofA 5+ Year Euro Government bond index rose by 10.0%.

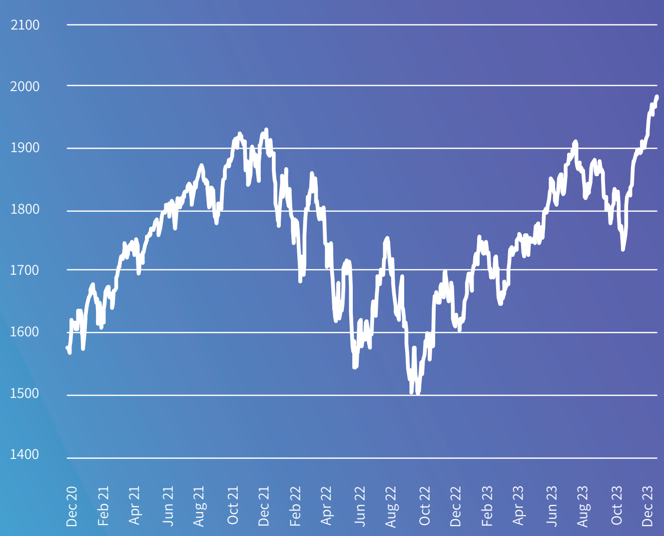
European investment grade (IG) corporate bonds rose by 5.6% in Q4, supported by sharp falls in yields in November and December. IG yields declined by 92bps to 3.60% and spreads narrowed by 16bps to 135bps over the period. Global high yield bonds returned 6.7% in Q4, with yields falling by 119bps to 6.88%, and spreads narrowed by 66bps to 290bps.

EM local debt rallied by 4.1% in Q4 and yields were down by 60bps to 6.19%. EM hard debt rose by 8.4%, benefiting from a fall in the US dollar, and yields declined by 109bps to 7.35%.

Meanwhile, peripheral Eurozone bond spreads narrowed. Italian 10-year spreads over the equivalent German bunds were down by 27bps to 167bps, while spreads for Spanish government bonds fell by 12bps to 97bps. Spreads narrowed as falling rates improved debt sustainability for more indebted nations like Italy, and the fall in spreads was also supported by expectations of rate cuts from the ECB as early as Q2 2024.

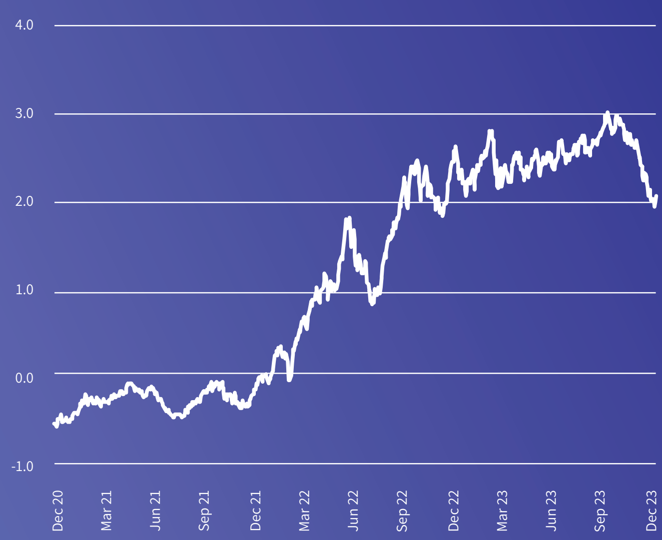
CHARTS OF THE QUARTER

Global Equities



Source: ILIM, Bloomberg. Data is accurate as at 31 December 2023.

Bonds – German 10-year yield



Source: ILIM, Bloomberg. Data is accurate as at 31 December 2023.

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	QTD Return (%)	YTD Return (%)	2022 Return (%)
MSCI Ireland	1.8	20.6	-21.1
MSCI United Kingdom	2.4	10.3	1.4
MSCI Europe ex UK	7.7	18.5	-11.9
MSCI North America	7.3	22.3	-13.8
MSCI Japan	3.7	16.7	-10.8
MSCI EM (Emerging Markets)	3.4	6.5	-14.5
MSCI AC World	6.5	18.6	-12.6

10-Year Yields	Yield last month (%)	2022 Yield (%)	2021 Yield (%)
US	3.88	3.87	1.51
Germany	2.02	2.57	-0.18
UK	3.54	3.67	0.97
Japan	0.61	0.42	0.07
Ireland	2.38	3.13	0.24
Italy	3.69	4.70	1.17
Greece	3.06	4.62	1.34
Portugal	2.66	3.59	0.47
Spain	2.99	3.66	0.57

FX Rates	End last month	2022 Rates	2021 Rates
U.S. Dollar per Euro	1.10	1.07	1.14
British Pounds per Euro	0.87	0.89	0.84
U.S. Dollar per British Pounds	1.27	1.21	1.35

Commodities (USD)	QTD Return (%)	YTD Return (%)	2022 Return (%)
Oil (Brent)	-19.2	-10.3	10.5
Gold (Oz)	11.6	13.1	-0.3
S&P Goldman Sachs Commodity Index	-10.7	-4.3	26.0

Source: ILIM, Bloomberg. Data is accurate as at 1 January 2023.

THE ILIM VIEW – LOOKING AHEAD

With inflation having clearly peaked and central banks now suggesting that the end of the tightening cycle could already have been reached, bond yields are expected to decline over the next 12 months. On a 12-month view, our base case is that German and US 10-year government bond yields fall modestly from year-end levels of 2.02% and 3.88% to 1.75% and 3.75% respectively.

We believe fixed income offers a strong risk-reward profile at this stage in the cycle, with the potential to offer protection if the economy slows; the asset class is attractive from an income perspective while also providing potential for capital gains via falling yields. We believe that the risks of materially higher bond yields have reduced, and we have increased confidence that, if the economy falters, major central banks will be able to cut rates to support growth. In that scenario, we would expect bonds to outperform to a greater extent.

Global equities were resilient in 2023 as recession fears receded and a peak in central bank policy rates has likely been reached. While global earnings are forecast to have been broadly flat in 2023, they have held up better than feared at the start of the year as sales have surprised to the upside in the better economic backdrop and the margin squeeze for corporates has been less than anticipated. Earnings are expected to grow by over 10.7% in 2024.

Equities remain expensive against both bonds and cash, given the high yields currently available on these assets. Equities are now trading above long-term price-to-earnings (PE) multiples, trading on a 12-month forward P/E multiple of 16.8x against a long-term average of 16.0x, but the outlook on a 12-month view is positive. Central banks are likely to pivot towards looser policy in 2024 as inflation continues to fall. An increasing probability of a soft landing, with a rebound in both growth and earnings in 2024, should also provide support.

Over the medium term, the rollout of AI should boost efficiencies and earnings across the whole market and allow equities to trade at higher valuation levels. The ongoing green-related capex cycle could also boost earnings over the medium term. Any short-term volatility in markets is likely to be offset by the above factors, resulting in positive returns on a 12-month time frame.

THE MONTH AHEAD

January

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
			11 US Inflation Rate YoY	12 GB GDP MoM US PPI MoM
15 DE Full Year GDP Growth	16 GB Unemployment Rate	17 GB Inflation rate YoY US Retail Sales MoM		19 JP Inflation Rate YoY
	23 JP BoJ Interest Rate Decision		25 DE Ifo Business Climate EA Deposit Facility Rate US GDP Growth rate QoQ (Adv)	26 DE Gfk Consumer Confidence
	30 EA GDP Growth Rate QoQ (Flash)	31 US Fed Interest Rate Decision		

Source: tradingeconomics.com

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The author cannot make a personal recommendation for any person and you should seek personal investment advice as to the suitability of any investment decision or strategy to your own needs and circumstances. Any comments on specific stocks are intended as an objective, independent view in relation to that stock generally, and not in relation to its suitability to any specific person.

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Figures referenced herein have been sourced from ILIM and Bloomberg. Forecast figures have been prepared by ILIM based on reasonable assumptions, internal data and data sourced from Bloomberg.

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